No. 10806.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

BARNHART-MORROW CONSOLIDATED,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF OF PETITIONER.

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I.

During the Year 1936 Petitioner Was Insolvent Within the Meaning of Section 14(d)(2) of the Revenue Act of 1936.

In determining whether petitioner was insolvent at the beginning of 1936 it must be remembered that the purpose cf the inquiry is to ascertain whether petitioner should be subjected to a penalty in the form of a surtax for not distributing profits received in November of that year. That Congress intended to be liberal in relieving distressed corporations from that penalty is shown by the fact that it exempted corporations which *for any portion of the taxable year* were in bankruptcy or insolvent and in receivership.

This liberal intent was given recognition in *United States v. Anderson Co.* (C. C. A. 7), 119 F. (2d) 343, where the taxpayer was held insolvent in 1936 despite earnings of $70,000.00 for the full year and a large preponderance of current assets over current liabilities, solely because its borrowing capacity was impaired by operating losses during a few months.

In *Artesian Water Company v. Commissioner* (C. C. A. 9), 125 F. (2d) 17, it appeared that the taxpayer had fixed assets greatly exceeding its liabilities, that it had a net income of $54,101.14 for the tax year in question, and that during the year it actually paid off $83,000.00 of its mortgage indebtedness of $183,250.00. This Honorable Court nevertheless held that the corporation was insolvent because it was unable to pay the balance of the mortgage indebtedness at maturity "either from its *current* assets" or with the reasonable use of its credit. In a footnote at the bottom of page 22 of their brief, counsel for respondent submit "that the *Artesian Water Co.* case cannot be interpreted categorically to mean that the corporation as distinguished from the receiver must be able to satisfy creditors." This is precisely what was held in that case. Although the receiver's attempts to refinance the mortgage had been unsuccessful because of questions raised as to his authority, there was nothing to indicate that he could not have obtained the necessary authorization; yet the Court said:

> "As stated above, *all* of the taxpayer's income bearing assets were pledged to the Insurance Company as security for the loans, and in view of the receivership *taxpayer's* hands were just as effectively tied as if it had been in bankruptcy." (Emphasis supplied.)

In the instant case all of petitioner's income bearing assets were held by trustees appointed in the case of *Julian v. Schwartz.* While the income received by the trustees could be used to pay current operating expenses, it could not be used to pay prior indebtedness of petitioner, for until the final determination of the case it remained an open question whether petitioner had any title to these assets or to the income derived therefrom. Furthermore, all of petitioner's remaining assets, such as they were, were held by Armour as receiver. Clearly, just as in the *Artesian Water Co.* case, petitioner's hands were as effectively tied as if it had been in bankruptcy.

The Tax Court accepted respondent's contention that petitioner was solvent if its debts could have been paid by the *receiver,* and then proceeded to assert that capital stocks carried at about $220,000.00 could have been sold or used as security for a loan to pay debts. The major portion of the discussion in our opening brief is devoted to showing that the capital stock in question was not stock of other corporations but was a mere bookkeeping item representing a type of promotion stock issued by petitioner. Counsel for respondent now recognize that the Tax Court made a glaring error, but argue that this is "unimportant" (Resp. Br. p. 21) for two reasons:

First, it is asserted that there is no proof of matured obligations. Counsel argue, for example, that accounts payable, standing substantially unchanged for two years, may not have become due. "Accounts payable" are defined in Webster's New International Dictionary as "balances at present due to others on current accounts." We submit that "accounts payable" are always matured obligations,

as are also "accrued taxes", "accrued payroll" and sums "due to stockholders."

Second, counsel argue that the receiver was able to "meet" these obligations by securing extensions of time from petitioner's creditors. To this argument there are several answers. To begin with, there is no suggestion in the record of any voluntary extension of time for payment by any creditor prior to October 28, 1936.

Counsel are mistaken in asserting (Resp. Br. p. 20) that Hardison had "previously" agreed to accept $7,000 in settlement of his claims. Those claims were not settled until December 11, 1936 [R. 192-3]. In view of the fact that an adverse decision in the case of *Julian v. Schwartz* would add to petitioner's obligations the duty of accounting for the proceeds of past production [R. 98-99], neither petitioner nor the receiver had any credit whatsoever until that case was finally determined.

Moreover, the statement of this Court in the *Artesian Water Co.* case that a corporation is solvent if it can "meet" its obligations does not imply that solvency may be achieved merely by inducing creditors to refrain from filing actions. Surely one does not "meet" his obligations by "stalling" his creditors! The Senate Finance Committee's report on Section 14 (d) (2) (C. B. 1939-1, Pt. 2, p. 687) defines cases in which a corporation is insolvent as those in which "its liabilities are in excess of its assets or it is unable to *pay* the claims of creditors *as they mature.*" It is established by the uncontradicted testimony of Harold C. Morton in this case that until October 28, 1936, petitioner was "without funds to pay their obligations or to conduct their affairs." [R. 119-120].

II.

Petitioner Was Entitled, in Computing Its Undistributed Net Income for 1936, to Deduct Its Deficit as of December 31, 1935.

The statement of counsel for respondent that petitioner "had full opportunity to adequately present its case before the Tax Court, and voluntarily and expressly chose to have the issue of the deficit credit decided on the record as it then stood" (Resp. Br. p. 23) was anticipated in our opening brief and fully refuted on pages 18-20. We will not repeat what was said in that brief, except to point out that the Tax Court first refused to permit the introduction of evidence at the hearing on recomputation and then denied a rehearing because the evidence offered was not newly discovered. Respondent is now lending support to what amounts to a denial of due process of law.

The fact that petitioner is a "wasting asset corporation", as that term is defined in the last paragraph of Section 346 of the Civil Code, does not, as suggested by opposing counsel (Resp. Br. pp. 26-27), render inapplicable the restrictions on payment of dividends contained in the first paragraph of that section. Section 346 permits payment of dividends either out of surplus *or* out of profits. As pointed out in *Ballentine, California Corporation Laws*, pp. 338-9, the section adopts both the "earned surplus rule" and the "net profits rule", earned surplus being the accumulated earnings or balance of profits since incorporation, and net profits the net income for a given period. The last paragraph merely permits *net profits* to be de-

termined, in the case of a wasting asset corporation, without deduction for depletion (*Ballentine, supra,* p. 349). It has no effect in the determination of whether or not there is an earned surplus; consequently, petitioner's $172,161.65 deficit is not reduced by prior depletion, much less by the total of almost $100,000.00 set aside for depletion *and depreciation.*

In November, 1936 [R. 198-9] petitioner received $112,000.00 from the trustees. Counsel for respondent conjure up the possibility that petitioner might therefore have been able to pay dividends in December "out of net profits earned during the preceding accounting period", within the meaning of Section 346 (2). In the first place, petitioner's accounting period was the calendar year [R. 193, 254, 279]. Petitioner could not arbitrarily have created a new period ending in November for the sole purpose of declaring a dividend, for the privilege of paying profits out of earnings during a special "dividend period" was eliminated by the 1933 amendment to Section 346. In the second place, petitioner was in any event prohibited from paying dividends during the first ten months of 1936 because of the continued existence of the deficit and therefore qualifies under Section 26 (c) (3) of the Revenue Act of 1936 as a corporation prohibited by law from paying dividends during the existence of a deficit.

In their brief, at page 26, counsel for respondent say that "the balance sheet in no way demonstrates that the

alleged deficit was in accumulated earnings and profits." True, but it constitutes at least *prima facie* evidence of that fact. A *demonstration* was what petitioner sought to make by presenting to the Tax Court on rehearing an analysis of the deficit account [R. 287], but petitioner was not given the opportunity. It seems clear, therefore, that if the balance sheet is not given full weight as *prima facie* evidence of a deficit in accumulated earnings and profits, it was an abuse of discretion and reversible error to deny petitioner the right to prove the deficit by further evidence.

III.

Petitioner Was Entitled to Deduct Receivership Expenses Paid in 1936 in Determining Its Net Income and Undisputed Net Income for That Year.

On the question of waiver, counsel for respondent cite *Commissioner v. Fortney Oil Co.* (C. C. A. 6), 125 F. (2d) 995, where the court said of certain questions raised by the taxpayer:

> "These questions were not considered by the Board, are not presented in the evidence, and cannot be considered here."

In the instant case the question as to petitioner's right to deduct receivership expenses *was* presented in the evidence [R. 83-5] and, despite the inadvertent statement of counsel for petitioner with respect to waiving all but certain issues, *was* considered by the Tax Court on petitioner's

motion for rehearing [R. 296-7]. As stated in our opening brief, page 33, we believe the issue is before this Honorable Court on its merits.

Respondent's argument on the merits is that the stipulation [R. 85] that receivership expenses were allowed as deductions "in and for the years in which they were definitely determined and approved by the Court in said cause of action No. 325061 wherein the said Ralph S. Armour was receiver" means that the receivership expenses were recognized as deductions "for the years the court approved them as proper" (Resp. Br. pp. 29-30) —that is, the years when the expenses were incurred by the receiver, as shown by the account approved by the court. This is an obvious misconstruction of the stipulation. The only years referred to in the stipulation are "the years *in which* they [the receivership expenses] were approved by the Court." The state court had no concern with the years in which particular expenditures might be deductible for tax purposes; it merely approved the account rendered by the receiver and directed payment of his expenses as stated therein [R. 198]. The years in which such approvals were given, however, were those adopted at the hearing in Washington on August 13, 1937 as fixing the time for deduction of the receivership expenses.

In a footnote at page 30 of their brief, counsel for respondent say that the receivers fees approved by the state court on November 12, 1936 [R. 197] included a $2,893.32 balance of fees due under an earlier court order. We do not know the source of counsel's information of this fact, if it is a fact; but certainly it does not appear in the record.

IV.

Petitioner Sufficiently Established the Loss Sustained in 1937 on Surrender of Well No. 16.

Counsel for respondent argue at some length (Resp. Br. pp. 31-34) that because the relinquishment of petitioner's interest in Well No. 16 relieved petitioner of the statutory burden of conditioning the well for abandonment, the transfer to Smith amounted to a "sale or exchange" within the meaning of Section 117(d) of the Revenue Act of 1936, and that the loss was therefore limited as a deduction to $2000.

It should be noted at the outset that although Section 16 of the Oil and Gas Conservation Law (Act 4916, General Laws of California) imposes upon the operator of a well a duty which may entail considerable expense, and this duty may be referred to as a statutory liability, it is not a financial liability in the sense of an indebtedness upon which judgment may be recovered. By Section 21, non-compliance is made a misdemeanor, subject to penalty by fine and/or imprisonment.

Counsel for respondent rely upon decisions holding that a voluntary surrender of mortgaged property in consideration of release of personal liability for the mortgage indebtedness is a sale within the meaning of Section 117(d). In such cases, however, the grantor receives a consideration from the mortgagee which is personal and not merely incident to ownership of the property. Where there is no personal liability on the part of the grantor, but the property is merely held subject to the lien of the mortgage, the transfer to the mortgagee is held not to

constitute a sale. *Commissioner v. Hoffman* (C. C. A. 2), 117 F. (2d) 987; *Stokes v. Commissioner* (C. C. A. 3), 124 F. (2d) 335. These cases were distinguished, but approved as consistent with the latest Supreme Court decisions, in *Commissioner v. Green* (C. C. A. 3), 126 F. (2d) 70, and *Myers,* 3 T. C. 1044.

Certainly the mere fact that a transfer is motivated by a desire to avoid the burdens of continued ownership cannot be sufficient to characterize the transfer as a "sale or exchange." As recently pointed out by the Supreme Court in *Helvering v. Williams Flaccus Oak Leather Co.,* 313 U. S. 247, 249, 85 L. Ed. 1310, 1312, these words in Section 117(d) must be given their "ordinary meaning." In *Stokes v. Commissioner, supra,* the court said:

> "And if, as a last resort, it is urged that being rid of a piece of real estate which is a source of burden instead of benefit is a sale, then every transfer is equally within the terms of the statute, and 'sale or exchange' must be taken to mean 'sale or any other transaction by which an owner divests himself of property.' A court is not privileged thus to rewrite legislative language, even though it might think such substitutions better carry out the policy than the language actually used by the lawmaking body."

In the instant case, moreover, petitioner was not at the time of the transfer to Smith under any *present* burden or liability, statutory or otherwise. The mere avoidance of a *future* liability incident to continued ownership cannot constitute a consideration for the particular transfer actually made. This was recognized in *Aberle v. Commissioner* (C. C. A. 3), 121 F. (2d) 726, although the facts in that case showed that the liability had already accrued when the transfer was made. The transfer was made by

the mortgagors to the mortgagee under an agreement whereby the latter undertook to accept a deed before January 1, 1935, or else to indemnify the mortgagors against 1935 property taxes. The transfer was held to be a sale, but only because the evidence showed it took place after January 1, 1935. The same principle was applied in the case of *Charles Strub,* Mem. B. T. A., January 23, 1942, C. C. H., Dec. 12400G. In that case the petitioner had acquired by assignment a leasehold interest in certain Los Angeles real property and later, by agreement with the lessor, he gratuitously assigned this lease to the latter's nominee. The Board member pointed out that at the time of this re-assignment petitioner had no liability for future rents except such as arose from privity of estate and added:

> "Since no covenants with regard to rental or otherwise were broken by him during the time the leasehold was held by him, there was no liability on his part running to the lessors which the lessors could, by any action on their part, release to petitioners. Therefore, there was no consideration moving to petitioners from the lessors in return for the re-assignment of petitioners' interest in the leasehold: and therefore such re-assignment can not be said to be a 'sale or exchange' of a capital asset within the meaning of Section 117(a), Revenue Act of 1934."

We have anticipated in our opening brief, at pages 38-40, the arguments now advanced by counsel for respondent as reasons for disregarding Petitioner's Exhibit 57.

On the question whether the depreciation on tangible well equipment taken by petitioner is the full amount "allowable", counsel cite *Rieck v. Heiner* (C. C. A. 3), 25

F. (2d) 453, as holding that book entries prove very little. In that case the Commissioner had recomputed the depreciation taken on the taxpayer's return; here the Commissioner challenged the entire loss claimed by petitioner and never even suggested that the depreciation deduction was too small.

With respect to the claim that petitioner *may have* deducted intangible drilling costs in prior years, we respectfully refer the Court to pages 45-47 of our opening brief. We repeat that under the decision in *Hardesty v. Commissioner* (C. C. A. 5), 127 F. (2d) 843, and other cases cited in our brief, petitioner was not given this right, because its agreement to drill the well was the consideration for an interest in the United Lease. The fact is they were *not* expensed, and petitioner was denied the opportunity to show this [R. 242].

Conclusion.

We believe this is a case in which the Commissioner, in his zeal to collect revenue, has disregarded his equal duty to deal fairly with the taxpayer. In the absence of any question raised in the notice of deficiency as to petitioner's books and balance sheets, and in the absence of any challenge or contradictory evidence offered by the Commissioner at the hearing, petitioner is entitled to the full probative value of the evidence adduced; and if this is insufficient, it is respectfully submitted that petitioner should be given the opportunity at a further hearing to present any additional evidence which may be required.

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